Chapter 1

De-SPAC - Key accounting and financial reporting considerations

This article aims to:
Discuss key accounting and financial reporting considerations for completion of the de-SPAC transaction.

Introduction

In our previous edition, we discussed how Special Purpose Acquisition Companies (SPAC) are gaining momentum as an alternate mode of going public globally. We also covered how SPAC transactions are different from a traditional Initial Public Offer (IPO) including specific regulatory considerations in India.

The merger of a SPAC and the target company, commonly referred to as a de-SPAC transaction may pose several challenges relating to accounting and financial reporting in addition to issues encountered in a traditional IPO. This could range from determination of the appropriate GAAP while preparing pre and post-merger financial statements, identification of the entity in the merger that should be treated as the acquirer for accounting purposes and accounting of share-based payment arrangements and complex financial instruments.

Continuing our discussion, in this article we aim to cover some of the key accounting and financial reporting considerations for completion of the de-SPAC transaction. SPACs are predominantly listed in the U.S. and challenges could arise where the private operating company (target) is a foreign business historically reporting under the International Financial Reporting Standards (IFRS) or another locally accepted standard such as Indian Accounting Standards. Therefore, we will deliberate on the accounting and financial reporting issues arising in a de-SPAC transaction.

Accounting and valuation of financial instruments

A SPAC IPO is typically structured to offer investors units of securities comprising shares of common stock and warrants to purchase additional shares of common stock. The evaluation of the accounting for contracts in an entity's own equity, such as warrants issued by a SPAC, requires a careful consideration of the specific facts and circumstances for each entity and each contract.

An entity would need to assess the contractual arrangement to determine classification of the financial instrument issued in a SPAC as a financial liability or as an equity. For this purpose, it would need to consider all the terms and conditions of the financial instrument, including relevant local laws, regulations and the entity's governing charter in effect at the date of classification. Also, specific consideration would need to be given in cases where an instrument contains some contingent settlement provisions to determine whether such an instrument would qualify as a liability or as an equity.

The U.S. Securities and Exchange Commission (SEC) has issued a staff statement on 12 April 2021 regarding their evaluation of a fact pattern relating to the accounting for warrants issued in connection with a SPAC's formation. In accordance with the guidance, if the warrants include conditions that could change the settlement amount, then such a condition would preclude the warrants from being indexed to the entity's stock. Thus, in such cases, the warrants would be classified as a liability measured at fair value, with changes in fair value in each period reported in earnings.

Accordingly, careful assessment of warrant arrangements will be required to ascertain if there are terms or conditions which can cause changes in settlement amount or can impact how the settlement is calculated.

Accounting for the acquisition, reverse acquisition, or recapitalisation

In a SPAC transaction, determination of which entity is the accounting acquirer involves significant judgement. An accounting acquirer is the one which obtains control of the acquiree. Further, it may also need to evaluate whether the SPAC merger would qualify as a 'reverse acquisition'. In a reverse acquisition, the legal acquirer - i.e. the entity that issues the securities - becomes the acquiree for accounting purposes and the legal acquiree becomes the acquirer for accounting purposes. The reverse acquisition is reflected in the consolidated financial statements of the legal acquirer, but not in any consolidated financial statements of the legal acquiree. If the target is a variable interest entity, then the primary beneficiary of the variable interest entity could be considered as the acquirer. This is especially important as typically SPACs are set up to evaluate and acquire a single or multiple operating businesses and usually these businesses fold into the SPAC to survive as the continuing listed entity. The determination of the accounting acquirer requires judgement and impacts the eventual purchase price allocation and valuation of the assets of the accounting acquiree vs the legal one. This can become more complicated when a SPAC acquires multiple entities with different businesses.

In certain cases, a reverse acquisition may fall in the scope of IFRS 2, *Share Based Payments*. For example, an unlisted operating entity that meets the definition of a business may want to obtain a stock exchange listing but want to avoid a public offering. The unlisted entity arranges for a non-operating listed entity (that does not meet the definition of a business) to acquire its equity interests in exchange for the equity interests of the listed entity. In this example, the listed entity is the legal acquirer because it issued its equity interests, and the unlisted entity is the legal acquiree because its equity interests were acquired. In such a case, the guidance in IFRS 3, *Business Combinations* on identifying the acquirer applies by analogy and would result in identifying the listed entity as the accounting acquiree and the unlisted entity as the accounting acquirer. However, because the listed entity is not a business, once the acquirer has been identified, IFRS 2 applies in accounting for the transaction, instead of IFRS 3[1].

Presentation issues

- **Change in capital structure:** A typical SPAC transaction could result in the change in the capital structure. In accordance with the SEC Staff Accounting Bulletin (SAB) – Topic 4.C dated 7 March 2011, changes in capital structure after the date of the latest reported balance sheet but before the release of the financial statements must be given retroactive effect in the balance sheet. An appropriately cross-referenced note should disclose the retroactive treatment, explain the change made and state the date the change became effective.
- **Reverse acquisitions and reverse recapitalisations:** The SEC staff, in its Financial Reporting Manual – Topic 12 considered a public shell reverse acquisition to be a capital transaction in substance, rather than a business combination i.e., the transaction is equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation accompanied by a recapitalisation. The accounting could be similar to that resulting from a reverse acquisition, except that no goodwill or other intangible assets would be recorded.

  In accordance with IFRS 3 (provided the definition of business is met), consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree) but described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to adjust retroactively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. Accordingly, the consolidated financial statements reflect the following:

  - The assets and liabilities of the legal subsidiary (the accounting acquirer) recognised and measured at their pre-combination carrying amounts.
  - The assets and liabilities of the legal parent (the accounting acquiree) recognised and measured in accordance with IFRS 3.
  - The retained earnings and other equity balances of the legal subsidiary (accounting acquirer) before the business combination.
  - The amount recognised as issued equity interests in the consolidated financial statements determined by adding the issued equity interest of the legal subsidiary (the accounting acquirer) outstanding immediately before the business combination to the fair value of the legal parent (accounting acquiree).
  - The non-controlling interest's proportionate share of the legal subsidiary's (accounting acquirer's) pre-combination carrying amounts of retained earnings and other equity interests.

1. Para 4.5.2360, Insights into IFRS, 17th Edition 2020/21, KPMG IFRG Limited.

Financial reporting complexities for SPAC IPOs involving foreign operating targets including which GAAP to apply

The financial reporting requirements pre- and post-merger differ depending on whether the registrant qualifies as a US domestic registrant or as a Foreign Private Issuer (FPI). US domestic registrants present their financial statements under the US GAAP. FPIs benefit from reduced reporting obligations, compared to the US domestic registrants. For instance, FPIs can choose among US GAAP, IFRS standards, as issued by the International Accounting Standards Board (IASB), or home country GAAP (with a reconciliation to US GAAP) when preparing financial statements to be provided in SEC filings.

Some of the pre- and post-merger financial reporting issues that may arise when the target is a foreign operating company are as follows:

Merger of a US-domiciled SPAC and a foreign target: When the proxy/registration statement is filed, the merger has not yet occurred, and may not occur at all if the SPAC's shareholders do not approve. Therefore, target's financial statements can be presented under IFRS standards as issued by the IASB, or a home country GAAP with a reconciliation to the US GAAP, in the proxy/registration statement.

A foreign target may avoid converting historical US GAAP financial statements for purposes of the proxy/registration statement, but it would still need US GAAP financial statements within four business days of completing the SPAC merger. Additionally, US GAAP adjustments are needed for the Article 11 proformas. Registrants (with the support of the target's management) should be prepared to address the need to convert the foreign target's financial statements to the US GAAP, generally shown in the Article 11 proformas, as a transaction accounting adjustment. This could pose challenge considering the short start-to-finish timeline of SPAC transactions.

US GAAP conversions may significantly affect finance processes, internal controls, system configurations, and other business processes. Therefore, it is critical to identify potential US GAAP conversion requirements before or during negotiations to avoid delays during the SPAC merger process and adequately prepare the target for life as a public company and US GAAP preparer.

Merger of a foreign-domiciled SPAC and a foreign target: In certain situations, the SPAC is a foreign-domiciled company with predominantly US shareholders; therefore, it reports to the SEC as a US domestic registrant pre-merger. After a merger with a foreign target, the post-merger registrant may be able to qualify as an FPI as a result of the shareholder composition and/or its foreign nexus.

FPI status would allow the foreign target to use IFRS Standards, as issued by the IASB, in its financial statements included in both the proxy/registration statement and ongoing reporting requirements. Also, the post-merger registrant would benefit from reduced financial reporting obligations, including the option to report under IFRS Standards on an ongoing basis.

While the regulations play an important role in determining the choice of GAAP to be followed, due consideration should also be paid to the GAAP followed by the listed peer companies. In a number of instances it may be beneficial to align with the peer companies choice of GAAP even though the regulation may allow the use of IFRS or home country GAAP in order to ensure better comparability with such peer companies.

Disclosure considerations

The SEC through its guidance dated 22 December 2020 highlighted certain disclosure considerations for SPACs, in connection with their IPOs and subsequent business combination transactions.

Some of the key disclosure considerations while presenting a business combination transaction to shareholders are as follows:

- Terms of additional financing necessary to complete the business combination and how the terms may impact the public shareholders.
- Approach taken to evaluate and decide to proceed with the identified transaction including how alternative targets may have been considered.
- Material factors that the board of directors considered in approving the identified transaction and the price paid to acquire the target operating company.
- Conflicts of interest of the sponsors, directors, officers and affiliates in presenting the opportunity to the SPAC, and how the SPAC addressed such matters.
- Qualitative and quantitative information about the consideration that the sponsors, directors, officers and their affiliates will receive upon completion of the transaction and the retained ownership they will have in the combined entity.
- Underwriting fees payable upon the completion of the business combination and the additional services the underwriter provided.

Auditing and other related considerations

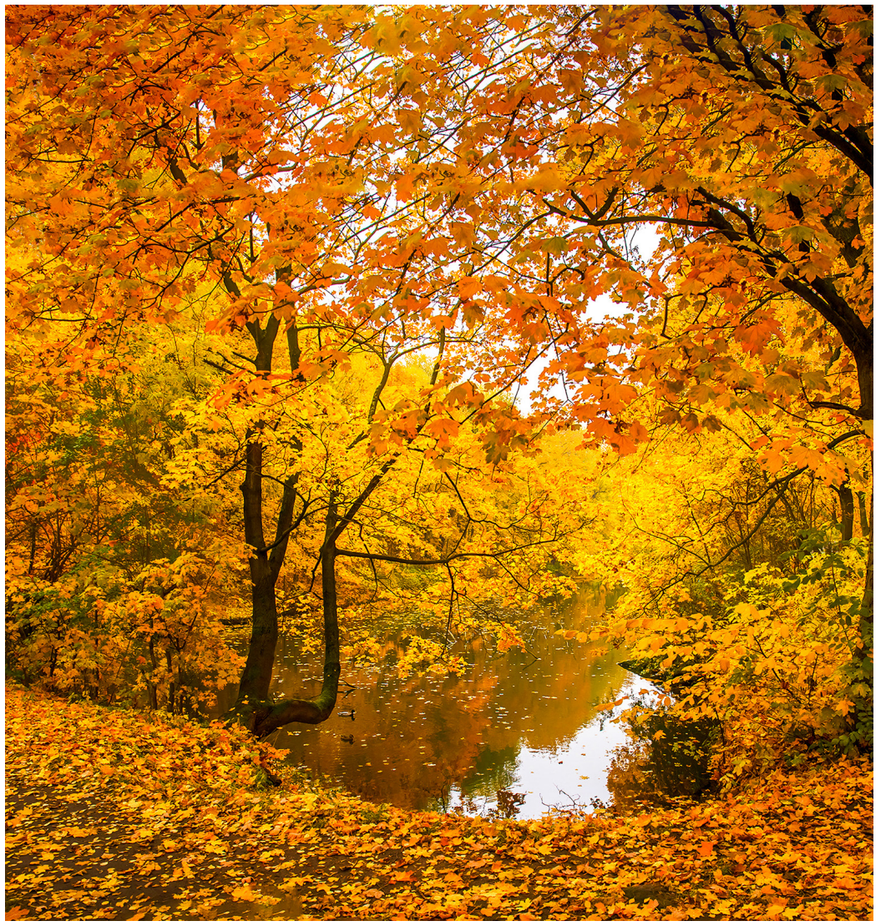
The financial statements of the target included in the proxy/registration statement must be audited under PCAOB auditing standards and by considering PCAOB[2] and SEC independence requirements. This requires careful planning and an assessment of the auditor's independence.

Auditors would need to change or augment the audit engagement team to include members with the appropriate experience in audits of operating company's financial statements.

Additionally, an auditor would also need to evaluate whether appropriate acceptance and continuance procedures have taken place when a formerly private audit client prepares to go public through a SPAC merger. Some of the other areas to be considered include reporting on critical audit matters/key audit matters, reduced materiality, enhanced risk assessment, scoping and process understanding and incremental audit quality control review procedures. To facilitate timely reporting and auditing, the combined public company should have finance and accounting professionals with sufficient knowledge of the relevant reporting requirements, including the applicable accounting requirements.

Next steps

Entities should consider the risks, complexities and challenges relating to SPAC mergers including careful consideration of the financial reporting considerations. Needless to say, quality and reliability of financial reporting and quality of audits of financial statements depends upon financial reporting participants including management, auditors and audit committee fulfiling their professional responsibilities by providing high quality information to the investors and other stakeholders.



2. Public Company Accounting Oversight Board